

# LAUNCHING PATENT LICENSING FOR AN EMERGING COMPANY\*

*Theodore A. Wood†*

## I. INTRODUCTION

One of the hallmarks of historically successful emerging companies is the ability to leverage its intellectual property (IP). Licensing key IP portfolio components, such as patents, is an essential tool in any successful leveraging strategy. In order for an emerging company to develop a successful licensing program, there are several factors the company must consider. To illustrate this point, the development of a licensing program is presented below from the perspective of a hypothetical emerging company, Electronic Innovations Inc. (Innovations).

Among the factors that Innovations must consider are the benefits and disadvantages of patent licensing, as well as some of the ways potential licensees avoid taking a license, and the basic types of licensing agreements. It is also essential for Innovations to consider the different types of financial consideration that can be used as a basis for those agreements. Although Innovations must be aggressive in developing its strategy, at the same time, it must learn to avoid several common licensing pitfalls.

Innovations is a small emerging company that has assembled an IP portfolio, including one issued patent and two pending patent applications. Its IP portfolio is designed to protect several key products. These products include unique and novel aspects of a commercial laser pointer -- the type designed to assist speakers when giving lectures or business presentations.

In the case of Innovations, its commercially successful "Laser II Pointer" is covered by the issued patent. Innovations' two pending applications cover an ongoing research and development (R&D) effort to develop a new "Blu-ray" laser pointer that capitalizes on the shorter wavelengths of blue lasers. The new Blu-ray pointer is envisioned to embody advanced laser pointer features that are highly coveted and anticipated within the business community. During the most recent

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† The author is an attorney with Sterne, Kessler, Goldstein & Fox, P.L.L.C., a Washington, D.C., intellectual property firm ([www.skgf.com](http://www.skgf.com)). The author expresses his appreciation for the assistance provided by Michael Messinger, Mike Lee, Don Featherstone, and Marv Guthrie of his firm. This paper does not represent the views of the law firm or any of its present or former clients.

development testing, Innovations' Blu-ray laser pointer finally achieved the performance metrics advertised in its soon to be released marketing materials.

To briefly recap, Innovations produces several products that are covered by its existing IP portfolio, including one issued patent and two pending patent applications. Innovations' chief technology officer believes that they have adequately protected its patent rights associated with its products. The goal for Innovations now, however, is to realize a reasonable return for its IP investment dollars by licensing its IP portfolio. To achieve this, there are several factors that Innovations must consider.

First, Innovations must determine whether one issued patent and two pending patent applications are sufficient to launch an effective patent licensing program. A related, but different, question is: Are its products sufficiently covered by the existing patent portfolio? That is, do the claims of its issued patent reasonably read on its existing products (e.g., the Laser II Pointer and the new Blu-ray technology based pointer)? Another important consideration for Innovations is whether there is now increased exposure to litigation due to the launch of its licensing program? Specifically, what are Innovations' chances of being sued for trying to enforce its IP rights through licensing of its IP portfolio? Perhaps a more basic question for Innovations is whether its patent portfolio is even ready for licensing. To this end, an even more fundamental question emerges: What constitutes a good patent portfolio that is ready for licensing?

## II. AN IP PORTFOLIO READY FOR LICENSING

Patent lawyers and other IP practitioners generally agree that an essential feature of a patent portfolio that is ready for licensing (i.e., mature) is a series of patents having patent claims covering different features and perspectives of the business's core technology and products. This approach provides a range of protection that makes it harder for a potential licensee to design around. A mature portfolio should desirably include at least one pending application such that the licensor (e.g., Innovations) will be able to draft patent claims to better match its evolving product line. Also, a mature IP portfolio should have at least one innovative patent, or pending application, with a set of fairly broad claims and a set of claims drafted from a different product perspective. The broad claims, however, should not be so broad as to appear invalid on its face to a potential licensee. Another feature of the mature patent portfolio is the inclusion of one or more fence patents, which are used to surround the competitor's technology with all conceivable improvements.

Assuming that Innovations' patent portfolio is ready for licensing, it must weigh the benefits of licensing against any disadvantages. While patent licensing carries many benefits for an emerging company, there are

also several real disadvantages.

### III. LICENSING ADVANTAGES/DISADVANTAGES

One major advantage of licensing is that it provides an immediate source of revenue, especially during periods of slight economic downturn, when many high technology companies are downsizing. Within this context, patent licensing is a relatively efficient mechanism for Innovations to realize a return on its IP investment, without the overhead associated with production and/or manufacturing. In fact, there are companies today with no other assets other than patents, and its only source of revenue is licensing royalties. Among many other benefits, patent licensing can possibly extend the access of the licensor (e.g., Innovations) to the superior resources of a licensee. These resources can help develop or improve the licensor's technology and help perfect the production of the licensor's products. One additional benefit of licensing, fostered by fence patents, is that Innovations can use its IP portfolio as a defensive tool to encourage cross-licensing with its competitors.

One of the major disadvantages of licensing is that it may actually help to create competition. Also, Innovations could easily end up partnered with a licensee that produces a more desirable product. Such an unfortunate arrangement could cut into the Innovations' sales to the extent that they lose more revenue due to lost sales than they gain through licensing.

Licensing may also reduce Innovations' level of control because a licensor cannot specifically manage all of the activities of the licensee. Additionally, Innovations could lose some degree of control over the quality and reputation of its products and technology. Innovations could also end up partially dependant on a particular technology and financial arrangement that may or not be consistent with its long term business objectives. It is many of these disadvantages, as well as other factors such as the obvious desire to remain financially independent, that leads many potential licensees to avoid taking a license.

### IV. WAYS POTENTIAL LICENSEES AVOID TAKING A LICENSE

One situation that enables potential licensees to avoid taking a license is when the licensor's portfolio is particularly vulnerable to "design around." For example, the patent claims might be so narrowly drafted or poorly written that a competitor can produce an equivalent product that is legally non-infringing. On the other hand, the patent claims may, in fact, be well written. However, the claims could have been prepared during an early stage of product development, such that the claims no longer read on the latest iteration of products. In short, the claims were prepared based upon an earlier product design that has since changed.

Moreover, some of the recent decisions by the Court of Appeals for the Federal Circuit (CAFC) have raised the bar in terms of patent application drafting and patent prosecution. For instance, application drafters must be particularly mindful of the way that claim terms will be interpreted, and how the claims themselves will be constructed by the courts. There is also additional case law from the CAFC regarding the impact of a patent application's prosecution history. This is especially true concerning the arguments and claim amendments that are made, during the patent's prosecution, to get around prior art applied by the United States Patent & Trademark Office (USPTO).

A potential licensee may also search for a prior art reference it believes may raise a substantial issue of patentability. Such prior art references have been referred to as "justifying references" because they justify the potential licensee in not taking a license. On the other hand, the potential licensee may attack, outright, the validity of a licensor's patent, using these justifying references to trigger USPTO procedures such as re-exams and public use hearings to formally re-examine the patent's validity. Finally, a potential licensee might seek to have a patent rendered unenforceable by arguing that during the prosecution of the licensor's patent, for example, the applicant concealed an important reference from the examiner.

After Innovations has studied the advantages and disadvantages of patent licensing, it must then decide what type of license would be most consistent with its needs. To this end, Innovations will likely focus on those licenses that are commonly used to license patents or patentable technology.

## V. TYPES OF LICENSING AGREEMENTS

By way of background, some of the more popular forms of licensing agreements include non-exclusive licenses, exclusive licenses, field of use licenses, sole licenses, and royalty based know-how licenses. The non-exclusive license agreement allows for more than one party to take a license to use the technology or product, whereas an exclusive license only permits licensing to one party. From Innovations' perspective, the exclusive license might be risky, especially, for example, if the licensee fails to take all the steps necessary to fully exploit Innovations' Blu-ray laser pointer technology.

As a compromise between an exclusive and a non-exclusive license, some licensors elect to use a field of use license. The field of use license permits the licensor to license the technology to multiple licensees simultaneously, but requires each licensee to restrict the technology use to a particular field or application. Thus, the field of use license provides some of the benefits of an exclusive license to the licensees. Finally, a sole license provides an exclusive grant to the licensee, similar to the exclusive

license. However, with the sole license, the licensor (e.g., Innovations) reserves the right to practice the invention.

Often, a license to use a patent or patentable technology does not specifically provide all of the technical knowledge of how to make and/or use the product. However, with a know-how license, the licensee is also paying to have the licensor provide this specific technical knowledge required to fully develop, make, and/or use the invention.

#### VI. FINANCIAL CONSIDERATION FOR PATENT LICENSES

Having selected a particular form of license, what type of financial consideration would be most appropriate for Innovations? There are several types of financial consideration to explore. First, many licensors require the payment of up front technology fees, or what is sometimes called an advance upon future royalties (i.e., fees that are not associated with performance). And, in some cases, the licensor could also request that the licensee reimburse the licensor for the cost of obtaining the patents or for preparing patent applications.

In other cases, however, licensees may pay a negotiated fixed price for a license known as a single payment, or paid up license. This single payment does not necessarily have to be in the form of a single payment, meaning that the payment could actually be satisfied in installments. However, the combined total of the installments cannot exceed the negotiated fixed price of the license, regardless of the level of performance. One of the challenges here is that if the licensor retains no rights in the technology, the license might be treated as a sale or an assignment. Therefore, the license agreement must clearly state that the agreement does not represent the sale of IP rights.

Equity consideration is an alternative to cash payments. With equity consideration, a potential licensee may elect to transfer shares of stock to the licensor at no cost, or at a reduced cost.. In fact, equity is the favorite type of consideration of venture capitalist and start-ups companies, and is even preferred by some licensors. This preference is based on the notion that smaller companies, such as start-ups, may not desire to pay out their valuable cash to cover costs such as up-front license fees. In fact, in some scenarios, equity consideration may even be better than running royalties because the equity might appreciate faster. There are several challenges, however, to equity consideration that will be discussed in greater detail below.

Royalties are the most common form of consideration paid to licensors and the specific amount of royalty payments can depend on many factors. When receiving royalty payments, however, the licensor should be able to audit the records of the licensee to have some sort of assurance that royalties are calculated properly.

Now that Innovations has ensured that its patent portfolio is ready for licensing and it has studied the advantages and disadvantages of licensing, the types of licenses, and types of financial consideration, there are several common pitfalls that Innovations must be aware of.

#### VII. COMMON LICENSING PITFALLS

First, Innovations and its licensees should perform reasonable due diligence with regard to the value of the IP that forms the basis of the agreement. In other words, Innovations should carefully determine the value of its IP to ensure that the price it is demanding for licensing its technology is proper. For example, what is the market value of Innovations' new Blu-ray laser technology? Additionally, what is the value of the technology embodied in Innovations' existing products, such as the Laser II Pointer? In support of this process, there are a number of well known techniques, which will not be discussed herein, that can be used to value Innovations' IP.

An additional due diligence consideration for Innovations is ensuring that its licensees will develop and market the licensed products in a timely manner. Innovations will also want to make sure that the licensee will not sit on the licensed technology, for example, for defensive purposes. Because of these additional due diligence considerations, Innovations may desire to institute milestone payments. Milestone payments are often preferred by both licensees and licensors as opposed to traditional due diligence clauses, which at times can be rather vague. Milestone payments are defacto payments to the licensee, in the form of credits against royalty obligations when the licensee achieves certain milestones. For example, a progress payment schedule might be based upon identifying specific milestones, such as filing an investigational new drug application with the Federal Drug Administration within 18 months. Another payment might be predicated upon a diligent pursuit of phase II clinical trials within thirty months, etc. Thus, by including specific milestone schedules, using vehicles such as milestone payments, licensors can increase the chances that licensees will develop and market the licensed product in a timely manner.

In negotiating the terms of the license agreement, an important aspect is quantifying the licensable subject matter. With patents, this quantification is relatively easy because the quantifiable subject matter is the claims of the patent. Quantifying the subject matter can be more difficult, however, when the subject matter is related to a patent application that has not yet been allowed. Quantifying the subject matter can also be more challenging when it involves know-how and trade secrets. In the case of patents, for example, know-how becomes a factor when the licensee requires more than the patent alone in order to develop the licensable technology. The licensee may also need the actual knowledge, and maybe

even trade secrets, of the licensor.

From the perspective of Innovations, its challenge as the licensor is managing this quantification process and resolving any ambiguities. Innovations' goal will be to not give away more, in terms of technology, than they stand to collect in licensing royalties. On the other hand, one might intuit that licensees might benefit from any ambiguities because of the possibility of getting more than they bargained for. But from the licensees' perspective, this licensable subject matter ambiguity could possibly increase their royalty rates. Thus, it is also in the licensees' best interest to carefully quantify the licensable subject matter so that they will know exactly what they are paying royalties on.

One approach to quantifying the licensable subject matter is, for example, to include a clause within the license agreement effectively covering "all patents, know-how, and trade secrets related to the patent or technology specified in. . ." A more effective way, however, is to start this process with a separate, negotiated memorandum of understanding (MOU).

Under the separate MOU approach, the life cycle of the patent license agreement essentially begins with patent attorneys and technical personnel from both sides (e.g., Innovations and the licensee) identifying and negotiating the key terms of the agreement. These key terms are then documented in a separate, negotiated, and signed, but non-binding, MOU. The key advantage of the MOU approach is to separate some of the more difficult business and/or technical issues from the complex legal issues. The fact that the MOU is non-binding relieves some of the psychological components normally associated with this type of negotiation, where each side is pushing to achieve exactly what it wants.

The MOU, therefore, provides a more informal setting where the parties can sit back and think through the difficult aspects of the licensing agreement. This informal setting enables the parties to define historically ambiguous deliverables, such as the know-how and trade secrets, in realistic terms before these terms are actually put in the licensing agreement. In essence, the more difficult aspects of the license are handled in a simpler agreement.

The MOU may require several iterations before all the key terms and issues are resolved. However, by the time the focus is directed to the actual licensing agreement, the MOU can simply be dropped into the actual licensing agreement itself. A couple of additional points are worth mentioning. Although the MOU is non-binding, it is somewhat difficult for the parties to back out of after having already agreed to and signed it. In other words, the fact that the MOU has already been signed provides a slight, but effective psychological benefit. Additionally, although the MOU adds another step in the process, in more cases than not, preparing the MOU creates a net time savings because it enables the development of the

actual agreement to run more smoothly and efficiently.

One of the difficult legal issues that may be best left for the agreement itself is the issue of indemnification (e.g., ensuring that the underlying patent will not later be declared invalid or unenforceable). From the perspective of the licensor, indemnification is a type of pitfall because it is something that licensors rarely want to provide. However, it is something that potential licensees almost always desire. Still, indemnification can be tricky because the licensor, for example, may really only know about potentially invalidating patents that have issued at the time the licensing agreement is signed. The licensor will not necessarily be aware of any potentially invalidating patent applications that might be issued as patents at a later time. One solution to this issue might be for the licensor to only indemnify against patents that have issued as of the date of the license.

Another potential licensing pitfall is the issue of joint development. For instance, what happens in the case of a know-how license, where the licensor and the licensee work together to develop a particular technology or product? In the case of Innovations' engineers working jointly with engineers from a potential licensee to develop a particular technology or product, which party owns the improvements to this joint work? One solution here is that one party will own the improvement, and the other party can take a license to use it.

Yet another example of a potential pitfall is the issue of equity consideration, noted briefly above. Equity is a form of licensing consideration that is an alternative to royalties. Although equity is often a preferred form of consideration by licensors and licensees alike, for a variety of reasons, equity consideration can come with strings attached. For example, equity might come in the form of shares of stock awarded to the licensor from the licensee. But, in this example, will those shares of stock also entitle the shareholder/licensor (e.g., Innovations) to a seat on the licensee's board of directors? At first glance, it might appear ideal for an emerging company, such as Innovations, to have a seat on the board of one of its licensees because of its ability to exert control. The problem, however, is that by being a member of the licensee's board, Innovations inherits a fiduciary duty to act in the best interest of the licensee. This arrangement could create a conflict of interest, especially if the best interests of the licensee are, or become, adversarial to the best interests of Innovations.

Moreover, by accepting equity as consideration, Innovations might incur a restriction on the sale of the stock, if nothing but for purposes of appearances. That is, most licensees may want to avoid the appearance created when one of their major stockholders begins selling off large amounts of stock. The solution here is for Innovations to hire a securities

attorney to make sure that all of the nuances of this type of financing arrangement are fully understood by all of the parties.

Also, when accepting equity consideration, it is imperative that the licensor understand the business plan of the potential licensee and vice versa, in order to understand how the license and the licensing arrangement might be best utilized.

One final potential pitfall is understanding the duration of the royalties. This understanding begins with an appreciation for what the licensee is actually paying royalties on. More to the point, is the licensee paying royalties on an issued patent? Or are royalties being paid on pending claims of a patent application? If, for example, royalties are being paid on an issued patent, it can be considered misuse for Innovations to run royalty payments beyond the term of its patent. Similarly, the issue of misuse might not only focus on beyond the end of the patent term, but can also focus on the period before the patent term begins. That is, will a license based on un-allowed or pending application claims be enforceable?

In this regard, it would not be unusual for Innovations to have language in its licensing agreement defining the subject matter of the agreement to be a licensed product that is covered by at least one valid claim of patent rights. This definition would then be followed up with the term "valid claim" being defined, for example, as any claim that has not been invalidated or finally rejected by the USPTO. And to cover the period before the patent issues, Innovations could stipulate that the licensee is paying for exclusivity or know-how. A potential solution would be to create a combination of patent royalties and know-how royalties. The period prior to the patent issuing would be covered, for example, by a grant of know-how. Once the patent is issued, the know-how royalties would disappear and the patent royalties would take over. Under this arrangement, Innovations could earn royalties not only on its issued patent, but also on its two pending patent applications.

#### VIII. CONCLUSION

Innovations can realize a return on its IP investment dollars by ensuring that its IP portfolio is ready for patent licensing. This IP portfolio can be made ready for licensing by securing a series of patents having patent claims covering different features and perspectives of its existing commercial laser pointers and its new Blu-ray technology. Before embarking on a particular licensing strategy, Innovations should study the benefits and disadvantages of licensing, along with the different types of licensing agreements. One of the challenges that Innovations will face, although surmountable, is being prepared for some of the ways that licensees avoid taking licenses. Finally, Innovations should examine the different types of financial consideration that can be paid or accepted for patent licenses, as well as the numerous licensing pitfalls. However, with

advice from competent legal counsel, Innovations should be able to avoid these pitfalls and successfully generate revenue by licensing its IP portfolio.